No. 8994.

In the United States Circuit Court of Appeals

For the Ninth Circuit.

T. E. KLIPSTEIN,

Appellant,

vs.

HERBERT P. SEARS, Trustee in Bankruptcy of the Estate of Globe Drug Company, Inc.,

Appellee.

PETITION FOR REHEARING.

HOMER JOHNSTONE,
SIDNEY H. WYSE,
1204 Bartlett Building, Los Angeles,
Attorneys for Appellant.

Parker & Baird Company, Law Printers, Los Angeles.

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PETITION FOR REHEARING.

To the Honorable Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

T. E. Klipstein, appellant in the above cause, respectfully requests a rehearing of the appeal in said cause, for the purpose of more fully considering the jurisdictional questions and other matters set forth in this petition.

In its opinion sustaining the decree of the District Court, this Court rested its decision not upon either of the two theories of liability set out in the pleadings and extensively argued at the trial and in the briefs, but upon Section 366 of the Civil Code of California, a statutory provision not previously considered in the case.

The grounds of this petition are that, in basing its decision on this section, this Court sustained a recovery not warranted by the facts, on a cause of action over which the District Court does not have jurisdiction.

In the Absence of Diversity of Citizenship, the District Court Has No Jurisdiction Over an Action by a Trustee in Bankruptcy Under Section 366 of the Civil Code.

In the opinion of this Court liability is sustained under Section 366 of the Civil Code. The nature of plaintiff's cause of action under this section is described as follows:

> "This is a suit to enforce a right of the corporation by the trustee against the director for his illegal acts. Whether the stockholders of the bankrupt or its creditors will benefit by recovery is of no moment here. The right enforced exists whether there are creditors or not." (Opinion, p. 7.)

Such a cause of action is one over which the federal courts have no jurisdiction in the absence of diversity of citizenship. This conclusion follows from well settled principles of federal jurisprudence.

The federal courts are courts of limited jurisdiction. There is a continuing presumption against the existence of such jurisdiction and a continuing burden upon the proponent to overcome such presumption, on the record, when the question is raised at any time. (*Turner v. Bank of North America,* 4 U. S. 8, 1 L. Ed. 718 (1799); *McNutt v. General Motors Acceptance Corporation,* 298 U. S. 178, 56 S. Ct. 780 (1936); *Celite Corporation v. Dicalite Company,* 96 Fed. (2d) 242 (C.C.A. 9th, 1938), *cert. den.* 59 S. Ct. 101; *Royalty Service Corporation v. City of Los Angeles,* 98 Fed. (2d) 551 (C.C.A. 9th, 1938). In the instant case this objection was, of course, made throughout. [See Assignment of Errors, No. I, Tr. p. 71; No. VII, Tr. p. 76; No. XX, Tr. p. 85.]

Under the provisions of the National Bankruptcy Act in effect at the time of the transactions here in question (Act of July 1, 1898, c. 541, 40 Stats. 565, as amended to 1936), a trustee can sue in the federal courts only when the bankrupt himself could so have sued, subject to three expressly provided exceptions. (*Matthew v. Coppin,* 32 Fed. (2d) 100 (C.C.A. 9th, 1929); *In re Prima Company,* 98 Fed. (2d) 952 (C.C.A. 7th, 1938); *Cook v. Glover,* 22 Fed. Supp. 531 (D. C. E. D. Ill., 1938.)

The applicable provisions of the Act are contained in Sections 23, 60 (b), 67 (e) and 70 (e). Section 23 reads as follows:

> "Section 23. a. The United States district courts shall have jurisdiction of all controversies at law and in equity, as distinguished from proceedings in bankruptcy, between trustees as such and adverse claimants concerning the property acquired or claimed by the trustees, in the same manner and to the same extent only as though bankruptcy proceedings had not been instituted and such controversies had been between the bankrupts and such adverse claimants.
>
> "b. Suits by the trustee shall be brought or prosecuted only in the courts where the bankrupt, whose estate is being administered by such trustee, might have brought or prosecuted them if proceedings in bankruptcy had not been instituted, unless by consent of the proposed defendant, except suits for the recovery of property under section 60, subdivision b; section 67, subdivision e; and section 70, subdivision e."

There is no question but that this action is a plenary suit as distinguished from "proceedings in bankruptcy".

Compare appellee's brief, page 5; *In re Prima Company, supra.* Nor is there any question of "consent". See *Matthew v. Coppin, supra.*

Of the three types of suits excepted from the general rule only one, that provided by Section 70 (e), could be relied on by appellee here. Section 60 (b) relates only to transfers of property or judgments made or suffered by the bankrupt, within four months of bankruptcy, while insolvent. In such cases the trustee may recover the property transferred or avoid the judgment. Here, the opinion of this Court expressly recognizes the lack of any evidence of insolvency. Moreover, there was, of course, no property transferred within the four months period, the assets of the bankrupt not being reduced by the execution of the note which was never paid and was returned by Klipstein to the corporation. [Tr. p. 61.] The only right the trustee might have in any event under Section 60 (b) would be to invalidate the judgment obtained by Klipstein against the bankrupt. This relief could, of course, be granted in these proceedings but the question is moot as the claim based on the judgment was waived. [Tr. p. 61.]

Section 67 (e), not relied on by Sears (see Appellee's Br. p. 5) concerns transfers of property made while insolvent or with intend to defraud creditors, both of which circumstances are explicitly found lacking by this Court in its opinion.

It follows that jurisdiction does not exist in this case unless appellee has pleaded and proved a cause of action

under Section 70 (e) of the Act. This section reads as follows:

> "Section 70. e. The trustee may avoid any transfer by the bankrupt of his property which any creditor of such bankrupt might have avoided, and may recover the property so transferred, or its value from the person to whom it was transferred, . . . For the purpose of such recovery any court of bankruptcy as hereinbefore defined, and any State court which would have had jurisdiction if bankruptcy had not intervened, shall have concurrent jurisdiction."

The crucial question is therefore whether or not the cause of action created by Section 366 of the Civil Code is one assertible by creditors of the affected corporation. A negative answer to this question is implicit in the portion of the opinion of this Court quoted *supra* in this petition.

Section 366 creates a liability dependent solely upon the consent or lack of consent of a certain proportion of the voting shares of a corporation, not upon solvency or insolvency, or the existence or absence of creditors. In the absence of other circumstances, such as insolvency, no creditor could complain of any loan or guaranty made in violation of Section 366. It would certainly be an anomaly to hold that creditors had a cause of action under this section, which right was subject to defeat by the consent of stockholders of a corporation to a transaction otherwise illegal. (Compare the analogous provisions of the Bank Act, 1909 Stat. & Amdts., p. 87, as

amended, General Laws of California (Deering, 1937), Act 652, Sections 65 and 83.)

Reference to the surrounding sections of the Civil Code confirms this interpretation. Sections 363, 364 and 365 cover situations where creditors are affected and in each of these sections creditors are specifically mentioned and their remedies prescribed. Such provisions are significantly omitted from Section 366 and the succeeding sections, which relate purely to infra-corporate matters.

It seems obvious, therefore, that the liability created by Section 366 is a liability to the corporation and that no creditor could attack transactions in violation of that section if the corporation itself acquiesced therein. The remedy created is simply an action by the corporation against any implicated director upon a guaranty implied in law by reason of such director's "illegal acts". There is involved no transfer which any creditor might avoid within the meaning of Section 70 (e) of the Bankruptcy Act (or any action "null and void as against the creditors" within the meaning of Section 67 (e), if that section otherwise applied). See, in general, *Dominguez Land Corporation v. Daugherty,* 196 Cal. 468, 238 Pac. 703 (1925).

The federal courts have no jurisdiction over such an action, when brought by a trustee in bankruptcy, unless diversity of citizenship is present. (*Park v. Cameron,* 237 U. S. 616, 35 S. Ct. 719 (1915); *Kelley v. Gill,* 245 U. S. 116, 38 S. Ct. 38 (1917); *Carmichael v. Barrett,* 28 Fed. (2d) 692 (C.C.A. 5th, 1928); *Lowenstein v. Reikes,* 60 Fed. (2d) 933 (C.C.A. 2d, 1932), *cert. den.* 287 U. S. 669, 53 S. Ct. 315; *Siegel v. Municipal Capital Corporation,* 102 Fed. (2d) 905 (C.C.A. 2d, 1939).

No Cause of Action Exists in Any Event Under Section 366, on the Facts of This Case.

Apart from the question of the lack of jurisdiction, no recovery could be sustained in any court under Section 366, on the facts of this case. That section imposes liability only where certain actions are taken without the consent of two-thirds of the stock held by persons not involved. Here all the stock of the bankrupt, except that held as security by Klipstein, was beneficially owned by Stelzner. [Tr. p. 55.] The corporation itself has no complaint under these circumstances. (*Sargent v. Palace Cafe Co.,* 175 Cal. 737, 167 Pac. 146 (1917); *Scales v. Holje,* 41 Cal. App. 733, 183 Pac. 308 (1919).) Moreover, Section 366 provides that the offending persons are liable to the corporation "as guarantors" for the repayment of the loan or to the extent necessary to hold the corporation harmless from any prohibited guaranty. Here, since no money left the corporation, there was nothing to repay. Nor did the corporation suffer liability by guaranteeing the obligation of Stelzner and Klipstein, if the transaction could be so construed. It suffered only a judgment which was never paid, all rights under which have been waived, and which in no way injured the corporation or operated as a preference. As a matter of fact it is admittedly true that Globe Drug Company never suffered injury in any way by any act of Klipstein in connection with the note executed on October 19, 1935, or by any subsequent act. Appellee has not contended otherwise.

This case was tried to determine the question whether any liability existed by reason of the withdrawals of cash from the bankrupt to apply upon the Stelzner note. The trial court heard the evidence and concluded as a matter of law that "all the payments made out of said corporation's funds" were illegal, and gave judgment accordingly. The briefs filed by both parties take up at length the law applicable to the question of liability based on the fact of such payments.

This Court, in its opinion, based its affirmance not on the fact of such cash withdrawals, heretofore regarded as the sole basis of liability, but upon other facts and circumstances, characterized by appellee himself as "having nothing to do with the extent of the recovery sought and awarded" (Br. p. 3), and not adequately briefed. Appellant Klipstein respectfully requests that the appeal be reheard for the purpose of more fully presenting the new questions raised by the decision of this Court, and particularly for consideration of appellant's contention that by changing the cause of action from one assertible by creditors to one assertible only by the bankrupt itself, the sole basis for federal jurisdiction under the Bankruptcy Act immediately ceases.

Respectfully submitted,

HOMER JOHNSTONE,

SIDNEY H. WYSE,

Attorneys for Appellant.

1204 Bartlett Bldg., Los Angeles, California,

Certificate of Counsel.

The undersigned, attorneys for the appellant in the above cause, do hereby certify that in our judgment the above and foregoing petition is well founded and that it is not interposed for the purpose of delay.

HOMER JOHNSTONE,

SIDNEY H. WYSE,

Attorneys for Appellant.